

Behind the Informal Economy: Estimating, Explaining, Counteracting

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by Guoda Steponaviciene, Vice-president, LFMI

The essence of an informal economy is to escape from being measured and captured; therefore both definition and methodologies shall be treated only as a way of approximation more than elsewhere in the economy in general. The informal economy is particularly flexible in reacting to changes in the regulatory framework - every new prohibition or regulation widens its scope and size. What was formal and legitimate yesterday can become informal today, for instance, the business of individual tours by boats before and after introducing new standards for passenger boats or kiosk owners business before and after introducing the requirements to use cash registers.

It is universally recognized that official statistics fails to reflect all the activities in the national economy. The informal economy exists in all countries, although those, which are in a process on transition, provide additional space for its existence.

In this paper the term "informal economy" refers to economic activities which are either illegal or, if legal, go unreported (or partly unreported) in order to avoid taxes or state regulation. The illegal economy includes any activity prohibited by law. Household economy, including activities such as babysitting, construction and repair services or garden work grounded in personal relationships or recommendations, is excluded from the concept of the informal economy.

The Lithuanian Department of Statistics (LDS) normally adjusts GDP in an upward direction to include the informal economy. Its size, however, was measured only once - in 1995 when it was estimated to be 23.4 percent of GDP. In this number 16 percentage points were included for economic reasons and 7.4 points - for statistical reasons, for instance, when companies fail to submit periodic reports to the Department of Statistics (although the underlying activities can hardly be considered as informal from our standpoint). Illegal activities were excluded from the analysis on the grounds that they are largely of international nature. The main method used by the LDS in measuring the informal economy was an anonymous opinion poll of tax inspectors, state social insurance fund employees as well as interviews with randomly picked individuals. Salaries and wages were adjusted on the assumption that they could not be lower in private enterprises than in state-owned entities, an assumption which is highly questionable.

The Lithuanian Free Market Institute conducts regular, semi-annual surveys of market participants' expectations since 1997. The informal economy is one of the issues under analysis. The survey is based on the expert consensus paradigm originating from the theory of rational expectations. According to this theory, market participants use all available information to make estimates and forecasts. It is the expectations of market participants that determine their actions and the trends in economic development. LFMI's survey participants include managers, financial analysts and other employees of successful business enterprises. They are asked to provide estimates and forecasts of Lithuania's economic variables based on all available information. The rationale for our survey is the obvious mismatch between the official statistics and reality (the number of cars in the streets, housing purchases, cafes' turnover, etc.) which most investors find rather confusing.

LFMI survey results

The results of the LFMI's surveys show that the informal economy in Lithuania has been steadily shrinking. This seems to indicate a positive trend at first glance, but without knowing the cause of the informal economy and its decline interpretation of the figures can be superficial. People who for various reasons cannot find their place in the formal economy can either go informal or turn to the labour exchange or their municipality for social support. A comparably low level of the informal economy can be indicative of a lack of entrepreneurship in society and this is very likely to be the case for Lithuania.

In exploring the phenomenon of the informal economy it is not the numbers but the causes behind them that matter the most. The roots of a shadow economy lie in the burden of taxes and other government regulations; other factors include the quality of state administration and services, the volume of cash transactions, price differences in neighbouring countries and the general economic situation. The reasons for an individual to go informal are manifold, but one thing is clear: if business conditions are favourable the risk of going informal does not pay off.

From the perspectives of policy decision-making finding measures that would make informal business activity less attractive is crucial. For the shadow sector to contract and, more importantly, for the formal economy to expand, it is essential to have:

- minimum taxes and regulations, including legal provisions on starting a business, employment regulations, licensing rules, etc.;
- simple and efficient administration;
- equal and transparent rules (e.g., no tax exemptions, minimal discretionary powers of public officials to interpret and apply legal provisions) and small bureaucracy;
- clear procedures for settling tax and other business disputes;
- reasonable fines;
- property and business security (e.g., law enforcement);
- stability of the legal system;
- corporate development (more companies investing in brand name, publicity, etc.);
- higher general level of income.

The Lithuanian Free Market Institute's motto provides a suitable summary of what has been said: if you don't create a free market, a black market will emerge.